**Internal Revenue Service**

# memorandum

CC:TL-N-3303-88
Br2:JAButler

date: APR 22 1988

to: District Counsel, San Francisco W:SF
Attn: Paul J. Krug

from: Director, Tax Litigation Division CC:TL

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subject: [redacted]

This memorandum responds to your written request for technical advice dated February 3, 1988. This case is scheduled for trial on [redacted].

ISSUE

Whether [redacted] is entitled to use ACRS and to a credit for its investment in a [redacted] orchard as used property.

CONCLUSION

[redacted] is not entitled to use ACRS and to a credit for its investment in the orchard as used property because it did not retain control over the orchard when it entered into the lease agreement with [redacted].

FACTS

Your request arises out of what might appear to be an inconsistency between a prior technical advice memorandum from the Tax Litigation Division ("TL Memorandum") dated May 8, 1986, which concludes that [redacted] is not entitled to either the investment tax credit or ACRS deductions and a National Office Technical Advice Memorandum ("NOTA Memorandum") dated August 25, 1986, which reaches a different conclusion regarding a different taxpayer on similar, but not identical, facts. Both matters involve [redacted]. Beginning in [redacted], [redacted] sold a number of its orchards to various investors and simultaneously entered into farming or agricultural contracts for those orchards.

At issue in both memoranda was whether the contract amounted to a lease or a management agreement. If the contract was a lease, or [redacted] otherwise continued to use the orchards after their sale, [redacted] or the other taxpayers would not be entitled to investment credit or use of ACRS with respect to the

orchards. See our technical advice memorandum of May 8, 1986, for a discussion of the statutory and regulatory basis for such a result.

A. The Contracts

1. Farming Contract

This contract was analyzed in the NOTA Memorandum. Its major points are summarized as follows:

The taxpayer entered into a farming contract with [redacted] which required [redacted] to perform, to the best of its skill and ability, all necessary services for the proper care of the orchard and for the cultivation and harvesting of the [redacted] grown on the orchard. The farming contract was negotiated at arm's length and is similar to other agreements entered into by [redacted] with, or offered by [redacted] to, third parties. Compensation paid to [redacted] is represented to be reasonable in amount for the services provided. [redacted]'s compensation under the farming contract is payable regardless whether such compensation exceeds taxpayer's revenue from [redacted] sales.

[redacted] receives as compensation reimbursement of its direct costs (including an allocable portion of its overhead) and, beginning in [redacted], two incentive fees for each pound of [redacted] harvested in excess of stated amounts and a percentage of the amount of revenues received by the taxpayer from the sale of [redacted].

[redacted] agreed to follow all reasonable directives of the taxpayer with respect to the farming of the orchard. From time to time, the taxpayer specified that certain farming practices or certain materials be used in the operation of the orchard, and [redacted] complied with such directives. For example, the taxpayer (i) specified that a certain variety of tree, rather than a mix of varieties proposed by [redacted], be used to replace storm-damaged trees; (ii) changed the criteria used to determine when to replace trees with falling productivity, so that such trees are replaced earlier than is the case under [redacted]'s customary procedures; (iii) directed that dead and dying trees be removed and the resulting holes in the orchard be filled with new trees; (iv) directed that certain areas that were being used for roads be planted with trees; (v) specified that greater levels and different combinations of fertilizer be used than those proposed by [redacted]; and (vi) ordered additional maintenance done on the orchard's windbreak trees.

[redacted] is required to keep accurate and complete records and to prepare monthly and yearly reports of its operations on behalf of the taxpayer. In addition, prior to each year, [redacted] is required to provide the taxpayer with an estimated budget for such year's operations.

[redacted] may subcontract to others portions of the work required under the farming contract; however, the taxpayer has no obligation to any party under any such subcontract. [redacted] indemnifies the taxpayer against all claims, obligations and liabilities that arise out of the performance of [redacted]'s obligations under the farming contract.

The taxpayer bears all of the farming and other risks of loss associated with the ownership and maintenance of the orchard and the cultivation and harvesting of [redacted]. Taxpayer is also required to pay operational expenses. The taxpayer bears the risk of increases in the cost of cultivation and harvesting; changes in the orchard's level of productivity; and (after [redacted]) changes in the market price of [redacted]. The taxpayer also bears the risk that trees will be lost because of natural forces like windstorms, rain, and disease.

The farming contract does not grant [redacted] a possessory interest in the orchard. [redacted] is granted access only to perform services for the benefit of the taxpayer; it has no right to use the orchard for its own benefit. [redacted] also has no right to exclude the taxpayer from the orchard. The taxpayer agreed not to interfere with [redacted]'s performance of services.

The farming contract runs for [redacted] years. However, it is terminable by the taxpayer upon [redacted] months' notice at the end of any calendar year. If the taxpayer terminates the farming contract, [redacted] may, if such termination is not due to a breach by [redacted], (i) continue to receive a portion of the incentive fee as liquidated damages until such time as the notes received by [redacted] in payment for the orchard are repaid in full and (ii) accelerate the payment of the notes if the taxpayer fails to hire a professionally qualified replacement to farm and harvest the orchard.

2. The Agricultural Lease

The Agricultural Lease ("lease") between [redacted] and [redacted] contains the following relevant provisions:

The lease commenced on [redacted], for a term of [redacted] years, unless terminated sooner by either party pursuant to the termination clause. Under the lease the premises, together with improvements, tenements, rights,

easements, privileges and appurtenances were demised to [redacted] in exchange for rent. One of the purposes for the lease is for [redacted] to farm the [redacted].

Essentially, [redacted] is required to conduct all such operations and perform all such services that are necessary in order to provide for the economical growth and yield of the orchard in accordance with the proven sound agricultural practices used by [redacted] on its own [redacted] orchards. [redacted] is required to follow [redacted]'s advice relating to farming matters. [redacted] has the right to request [redacted] to grow windbreak trees and to request additional reasonable services. [redacted] is permitted to substitute other suitable acreage having comparable [redacted] trees for the subject orchard. Also, [redacted]'s approval of plans was required for the installation of two irrigation systems. [redacted] charged [redacted] for the depreciation of one of these systems.

[redacted] is to conduct all the harvesting services in accordance with proven sound practices. [redacted] is also in charge of the employment of personnel. While [redacted] can subcontract some of the work, it cannot subcontract its duties under the lease in their entirety. [redacted] is required to indemnify and hold [redacted] harmless from and against any and all claims, obligations, liabilities or demands with respect to and arising out of the performance of [redacted]'s obligations under the lease and the employment of [redacted]'s personnel and agents on [redacted]'s land.

[redacted] is required to keep full and accurate accounts of all operating expenses, etc., for [redacted]'s inspection and for an annual independent audit.

[redacted], as the owner of the land is required to take any and all such actions as are customarily taken by a landowner in the husbanding of his property, including without limitation the making of surveys, the payment of taxes and assessments, the procurement of necessary permits and licenses, the insurance of properties (including trees), the insurance against liabilities, and the compliance with all land use laws, ordinances and regulations. [redacted] is required to pay all of the expenses relating to the land and orchards thereon. [redacted] can request [redacted] to assist it in the making of surveys, the processing of tax appeals and the procurement of necessary permits, licenses, etc.

The agricultural risks associated with any growing crop and the natural risks in the area are recognized and assumed by [redacted]. Additionally, [redacted] assumed the

natural risks such as, but not limited to, earthquakes, volcanic eruptions, floods, winds, etc., and agricultural risks. In the event of the destruction of any or all of [redacted]'s land, [redacted] is to bear the expense of restoring the premises to the same condition as prior to the destruction.

The rental due from [redacted] to [redacted] is offset by the reimbursable costs and the management fee due from [redacted] to [redacted]. Reimbursable costs include such items as hourly wages, overtime pay, payroll taxes, and other expenses with respect to personnel working under the lease; amounts paid for replanted windbreak and [redacted] trees; costs for transportation; costs for fertilizers, herbicides, fungicides, rodenticides and other materials; costs for expendable tools and supplies; charges for certain other services and overhead; and repair and irrigation costs.

For each year of the lease, [redacted] is to pay to [redacted], in accordance with monthly statements, a management fee as compensation for services rendered under the lease. As rental, [redacted] purchases all the [redacted] produced on the orchard. In other words, the rentals are measured by the value of the [redacted].

Although the lease grants [redacted] a possessory interest in the land, [redacted] is to utilize the land only for the production of [redacted] and for no other use whatsoever. [redacted], at all times, has access to the leased orchards.

B. The Memoranda

Both memoranda focused upon the two key factors that distinguish a management contract from a lease: (1) control over the venture by the property owner and (2) risk-of-loss on the property owner. In the absence of such factors, the Tax Court has characterized agreements as leases..

1. Summary of TL Memorandum

This memorandum concluded that [redacted] did not have control over the orchard because: there is no "best efforts" clause in the lease; [redacted] did not have direct control over the expenses incurred by and funds generated from the orchard; [redacted] agreed to follow [redacted]'s advice as to the operation of the orchard; [redacted]'s inspection and examination right of the accounts was a minor supervisory control; and [redacted] was not directly obligated to contribute toward payment of operating costs.

The memorandum concluded that [redacted] did not bear the risk of loss because the indemnification clause shifted the risk of loss to [redacted]. The memorandum noted, however, that [redacted] assumed the risk of loss of destruction and agricultural risks associated with any growing crop. The memorandum reasoned that the bald fact that [redacted] is required to insure the property is not determinative.

2. Summary of NOTA Memorandum

The situation addressed in the NOTA Memorandum differed from that of [redacted] in that in the NOTA Memorandum there was a farming contract between the taxpayer and [redacted] plus a separate management contract between taxpayer and another corporation, Corp B. That there was a separate management corporation which actively supervised [redacted]'s compliance with the farming contract proved a significant factor in the NOTA Memorandum's conclusion that the taxpayer had retained control of the orchard.

With respect to the control test, the NOTA Memorandum concluded that the taxpayer and its manager, Corp B, retained sufficient control over the [redacted] orchards to warrant finding a contractual service arrangement between the taxpayer and [redacted]. Although the taxpayer did not directly control the production and harvesting of [redacted], because such activities were left to [redacted]'s discretion, the taxpayer did exercise a degree of control over the operation of the venture by including certain provisions in its agreements with [redacted]. Such provisions required [redacted] to submit annual operating budgets, and to submit regular monthly reports. In addition, [redacted] agreed to perform all services that are "necessary or desirable" "to the best of its skill and ability." This clause was deemed equivalent to a "best efforts" clause.

The taxpayer specified that certain farming practices or certain materials be used in the operation of the orchard. In each case, [redacted] complied with such directives. The taxpayer specified a certain variety of trees to be planted, changed the criteria used to determine when to replace trees, directed that certain areas be planted with trees, specified the fertilizer used and ordered additional maintenance on the orchard's windbreak trees.

The risk-of-loss test was less clear-cut than the control test. However, the NOTA Memorandum did not agree with the District Director that, as the new owner of the property, the taxpayer must assume all benefits and burdens of ownership. This interpretation was viewed as too restrictive, since any benefit or burden assumed by [redacted], no matter how minuscule and

remote, would make the taxpayer ineligible for ACRS. Risk-of-loss was characterized as an economic interest in the venture. The TA Memorandum reasoned that [redacted]'s risk-of-loss must be directly related to its obligations under the agreement in order for the anti-churning rules under I.R.C. § 168(e)(4)(A) to apply.

It was concluded that under the farming and [redacted] purchase agreements, the risk of loss rested squarely on the shoulders of the taxpayer. The taxpayer was required, when economically possible, to procure and maintain insurance with respect to the [redacted] trees. Furthermore, the taxpayer was required to maintain the [redacted] orchards in good condition, suitable for the farming of [redacted] trees. The taxpayer bore all of the farming risk of loss associated with the ownership and maintenance of the orchard and with the cultivation and harvesting of [redacted]. The taxpayer bore the risk of increases in the cost of cultivation and harvesting; changes in the orchard's level of productivity; and, after [redacted], changes in the market price of [redacted]. Moreover, the taxpayer bore all risks that the [redacted] trees would be damaged or destroyed due to natural or man-made disasters.

DISCUSSION

We will briefly review some of the pertinent case law distinguishing a lease from a management contract.

In State National Bank of El Paso v. United States ("El Paso") 509 F.2d 832 (5th Cir. 1975), a lease is defined as a transfer of an interest in and possession of property for a prescribed period of time in exchange for rent. Id. at 835. That case also sets forth four characteristics of a management contract:

> 1. major expenditures are subject to the approval of the employer;
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> 2. all operating expenses are paid by the employer;
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> 3. the employer's income depends on the profits of the business; and
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> 4. risk of loss is upon the employer.

Not long after the El Paso decision, the Tax Court held in Kingsbury v. Commissioner ("Kingsbury"), 65 TC 1068 (1976), that an operating agreement was in substance a lease rather than an employment contract. Some of the factors found relevant to this determination were:

1. the sole and exclusive right to conduct business on the premises is tantamount to the use and possession of the premises, property rights that are normally transferred by a lease and not by an employment contract;

2. in a typical employer-employee relationship the employer has some element of control over the employee;

3. renewal options are typically granted to lessees; they are not ordinarily granted to an employee under an employment contract; and

4. the agreement called for a fixed monthly rental with the risk of loss upon the operator of the business, not the owner.

The factors set forth in El Paso and Kingsbury provided the analytical foundation for two significant cases on point, Meagher v. Commissioner, T.C. Memo 1977-270, and McNabb v. United States, an unreported case (W.D. Wash. 1980, 81-1 USTC § 9143). In Meagher the Tax Court concluded that the existence of control over the venture by the property owner and risk of loss on the property owner are key factors indicating a management contract. Following that reasoning, the court held that petitioners' (owners') agreement with Relco Tank Lines, Inc. (Relco) for the leasing of owners' railroad tank car amounted to a management contract rather than a lease.

In Meagher the agreement was entitled, "Relco Tank Line, Inc. Management Contract," clearly indicating that the parties intended to enter into a management contract rather than a lease. The court, however, looked to the substance of the agreement rather than its title and form in order to determine its true character.

In concluding that the owners retained control over the tank car, the court stated, "While petitioners did not directly control the leasing activities of Relco with respect to their railroad car, they exercised a degree of control over the venture at the outset by including certain provisions in the agreement which controlled Relco's participation." Specifically, Relco was required to keep adequate records of the tank car's operation, to use its best efforts to arrange for the leasing of owner's tank car to shippers, to obtain insurance coverage for the tank car naming petitioners co-beneficiaries, and to pay the net earnings of the tank car to petitioners within ninety days after the end

of each calendar quarter. Thus, petitioners had sufficient control over the venture.

The Meagher court found that petitioners assumed the risk of loss under the agreement because petitioners agreed to reimburse Relco for expenses incurred and to defend, indemnify, and hold Relco harmless from and against all risk of loss or damage to the tank car, as well as all claims, damages, expenses or liabilities incurred as a result of the operation of the tank car. Also significant was the fact that petitioners received rent only if there was a net profit. The court found that petitioners assumed the risks of a normal business transaction, not mere passive investment or financing risks.

Opposite conclusions were reached in McNabb, supra, wherein it was held that an agreement between plaintiffs and AFCO Furniture Rentals, Inc., was a lease and not a management agreement. Under the terms of that agreement, AFCO had "full control over all furniture in the rental pool" and the "sole and exclusive authority to set rental rates." Although plaintiff had the right to withdraw from the pool upon thirty days' notice and to receive periodic operation and financial reports, plaintiffs had no means by which they could affect the operation of the rental pool. Therefore, the court held that plaintiffs had virtually no control over the furniture leasing activities under the agreement.

With respect to the risk of loss, AFCO was responsible for all overhead and operating expenses with the exception of personal property taxes, maintaining the furniture, and replacing destroyed or damaged furniture during the first three years after its acquisition. The agreement also provided that AFCO indemnify and hold the plaintiffs harmless from any and all damages arising from the rental or leasing of furniture in the rental pool. Thus, AFCO assumed virtually all of the operational risks.

The McNabb court held that Meagher was distinguishable in that in Meagher:

> 1. the taxpayer was responsible for all operating expenses;
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> 2. the taxpayer agreed to hold the managing agent harmless from all loss or damage to the tank car as well as all claims asserted against the managing agent arising out of its operation of the car, and;

3. the managing agent agreed to use its best efforts to arrange for the leasing of the car.

In McNabb the fact that the amount of rent depended on AFCO's ability to lease the furniture did not prevent the agreement from being a lease. Rather, the absence of a best efforts clause and the fact that AFCO was virtually free to use plaintiff's furniture as it saw fit supported the conclusion that the agreement was a lease.

The Meagher and McNabb decisions were heavily relied upon in Amerco v. Commissioner, 82 TC 654 (1984). In Amerco an arrangement between fleet owners and U-Haul was characterized as a lease. It was held that the fleet owners did not retain sufficient control where they had no ability to negotiate the terms and conditions of ownership and where U-Haul retained control over the day-to-day operations of the system. The fleet owners divested themselves of "all control over the manner, type, plus, amount or nature of performing said trailer operation expenses".

The fleet owners' right to enter the premises where their vehicles were being displayed for purposes of inspection, and right to find lessees for the vehicles were deemed illusory since the owners could not designate the locations where their vehicles would be displayed, nor were they ever so informed. Moreover, the facts that U-Haul was obliged to promote the welfare of the fleet owners and keep proper reports of income and expenses did not amount to control by the fleet owners.

It was also found that the fleet owners' risk of loss was limited. The fleet owners' liability for expenses was limited to their earnings from the venture. The owners were not required to supplement their original investment in order to pay for normal operating expenses. Also, U-Haul agreed to hold fleet owners harmless from all damages and liability arising out of the operation of the U-Haul rental equipment. U-Haul purchased public liability and property damage insurance, and ultimately this risk was imposed on the customers. The court held that lessor-lessee agreements can exist where rent is based exclusively on a fixed percentage of the gross income or profits derived from the property rented.

As stated in Amerco v. Commissioner, supra at 673, the inquiry into whether an agreement is a lease or a management contract is inherently factual, and differences in the rights and duties of the parties may tip the scale in the opposite direction. Nevertheless, from the foregoing case law it can be derived that a management contract can exist even if the owner

does not retain complete control over the venture. All that is necessary is for the owner to exercise a sufficient degree of control at the outset of the venture which allows it to affect the future operation of the venture. Likewise, the owner need not assume all risk of loss. However, the owner must be exposed to the risk of loss typically associated with the conduct of a business venture.

With this foundation, we will now turn our attention to the case at hand. First, we will consider the risk of loss factor and then the control factor.

We believe the risk of loss generally rests with [redacted], so that this factor favors the petitioner by evidencing a management contract. The situations considered in the NOTA Memorandum and the TL Memorandum are alike in this regard. Both orchard owners were required to obtain insurance on the orchard. In each instance, [redacted] would indemnify the owner against all claims, obligations and liabilities arising out of the performance of obligations under the contract. However, in both instances it was the owner of the orchard who paid the operating expenses and assumed the risks of the enterprise. In other words, although [redacted] assumed certain risks normally associated with the performance of a management contract, in both situations the orchard owner assumed the ownership and agricultural risks typically associated with operating an orchard business.1/

The difference we see between the two situations is one as to the overall control of the enterprise. The facts in the instant situation show that [redacted] was primarily in control; whereas, the facts in the situation considered in the NOTA Memorandum show the taxpayer was in control.

We see four major differences between the two situations with respect to the control factor. First, the agreement discussed in the NOTA is labeled a farming contract; whereas, the agreement with [redacted] is labeled a lease. A lessor generally gives up more control than someone hiring another to

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1/ We recognize we reached the opposite conclusion in the TL Memorandum. Apparently, we interpreted the indemnity clause in section 3.5 of the agreement to shift all risk of loss to [redacted]. We now interpret that clause as applicable to damages resulting from [redacted]'s performance under the contract. We do not believe that clause shifted to [redacted] the normal risk of loss associated with operation of a business enterprise or the risk of damage to the orchard itself not resulting from [redacted]'s actions.

perform his farming duties. Second, there was a third-party manager employed by the orchard owner in the situation considered in the NOTA Memorandum, but not in the instant situation. Employment of Corp. B to oversee [redacted]'s performance under the farming contract shows the extent of the taxpayer's involvement in the enterprise and is a fact particularly relied upon in the NOTA Memorandum. Third, the contract considered in the NOTA Memorandum contained a "best efforts" clause requiring [redacted] to apply a specific fixed standard in managing the orchard. This fixed standard controlled [redacted]'s performance under the contract. In the instant case, however, [redacted] was required only to use the agricultural standards it used at its own orchards. Since [redacted] established those standards itself, the ultimate control over the agricultural standards rested with [redacted], rather than [redacted]. Lastly, the NOTA Memorandum concerns a situation where [redacted] agreed to follow all reasonable directives of the taxpayer with respect farming of the orchard and, in fact, on a number of occasions such directives were made and followed. In the instant situation, however, [redacted] agreed to follow [redacted]'s advice regarding agricultural practices.

In short, we stand by the conclusion reached in the TL Memorandum. We see indications of both a lease and a management contract in the situations considered in both the NOTA Memorandum and the TL Memorandum. Neither situation presents a clear case and reasonable men could reach different conclusions in each instance. However, the situations are not identical and, in our opinion, the differences are sufficient to support a viable argument that the agreement between [redacted] and [redacted] was a lease or otherwise gave use of the orchard to [redacted]. For this reason, we recommend the issue be defended.2/

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2/ Of course, we no longer recommend defense with the same degree of conviction we had when we prepared the TL Memorandum. We now recognize [redacted] had the primary risk of loss associated with the orchard. Moreover, the existence of the NOTA Memorandum reaching a different conclusion on facts that are largely the same imposes a litigation hazard that did not exist when we prepared the TL Memorandum. Nonetheless, we continue to believe there is a viable argument that the control resting in [redacted] makes it a continued user of the orchard, distinguishing the NOTA Memorandum and forming a foundation for defense. Were we [redacted], we would be willing to offer [redacted] to [redacted] percent in settlement of this issue.

We leave to your office, however, the ultimate decision whether to litigate this issue or not. The issue is a factual one of no continuing importance to the administration of the tax laws. In the TL Memorandum, we discussed various facts that are unknown to us and should be explored by your office. Not knowing the outcome of such investigations, we are unable to make a fully informed recommendation as to defense. Moreover, since your office is developing those facts and the issue is an inherently factual one, we believe the decision is best made by your office after taking into account the recommendation of our office.

MARLENE GROSS

By: David C. Fegan

DAVID C. FEGAN
Acting Senior Technician Reviewer
Branch No. 2
Tax Litigation Division